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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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DANGER! MEN AT WORK. Having officially recognized the speculation which has been going on since the middle of last year, the New York Stock Exchange now raises a warning finger. As a public service, many of the leading member firms have taken advertising space in the newspapers in order to awaken the public to the dangers inherent in stock speculation. We can only assume that their motives are completely altruistic. I seem to remember, however, that one of the largest "warning" ads was placed by a member firm which only a few short months ago was promising (in very large ads) that the market would double over the next four years.

There are two interesting points which arise in regard to the "go slow" campaign. The first is that, unfortunately, the best way to draw attention to a speculative market is to caution people about sky-rocketing securities and the dangers connected with making a killing in stocks. The second point is that the recent campaign will probably demonstrate the utter futility of attempting to manipulate the primary trend of stocks. Hamilton and Rhea frequently stated that the primary trend of stocks and the economy was not susceptible to manipulation by any man or group of men. Therefore, assuming that the recent advertising campaign could succeed in frightening a few amateurs out of their holdings and assuming that it could succeed in casting a cloud of caution over the market, history demonstrates that the ensuing speculation would only be that much more tempestuous. A sold-out market within a primary bull trend resembles a bottle of beer sitting on a hot stove. When the flames finally take hold, one can hear the explosion all over the house.

QUESTION. Perhaps the most frequent question received here runs something like this: "You say this is the third phase of a great bull market, that this is the speculative or boom phase. You also say that you believe prices will go much higher as volume hits a possible 5-8 million shares per day. In view of all this, why should I not remain 100% invested?"

ANSWER. My own method of investing calls for 100% equity only during those times when I feel extremely confident. The market has changed vastly in the last six months, and the percentages as well as the safety factors are gradually moving against us. There is a great difference between being bullish in the first or second phases of a bull market--when the signs of rampant public participation are absent, and being bullish in the third phase--when informed investors are tending to distribute their stocks to a greedy crowd.

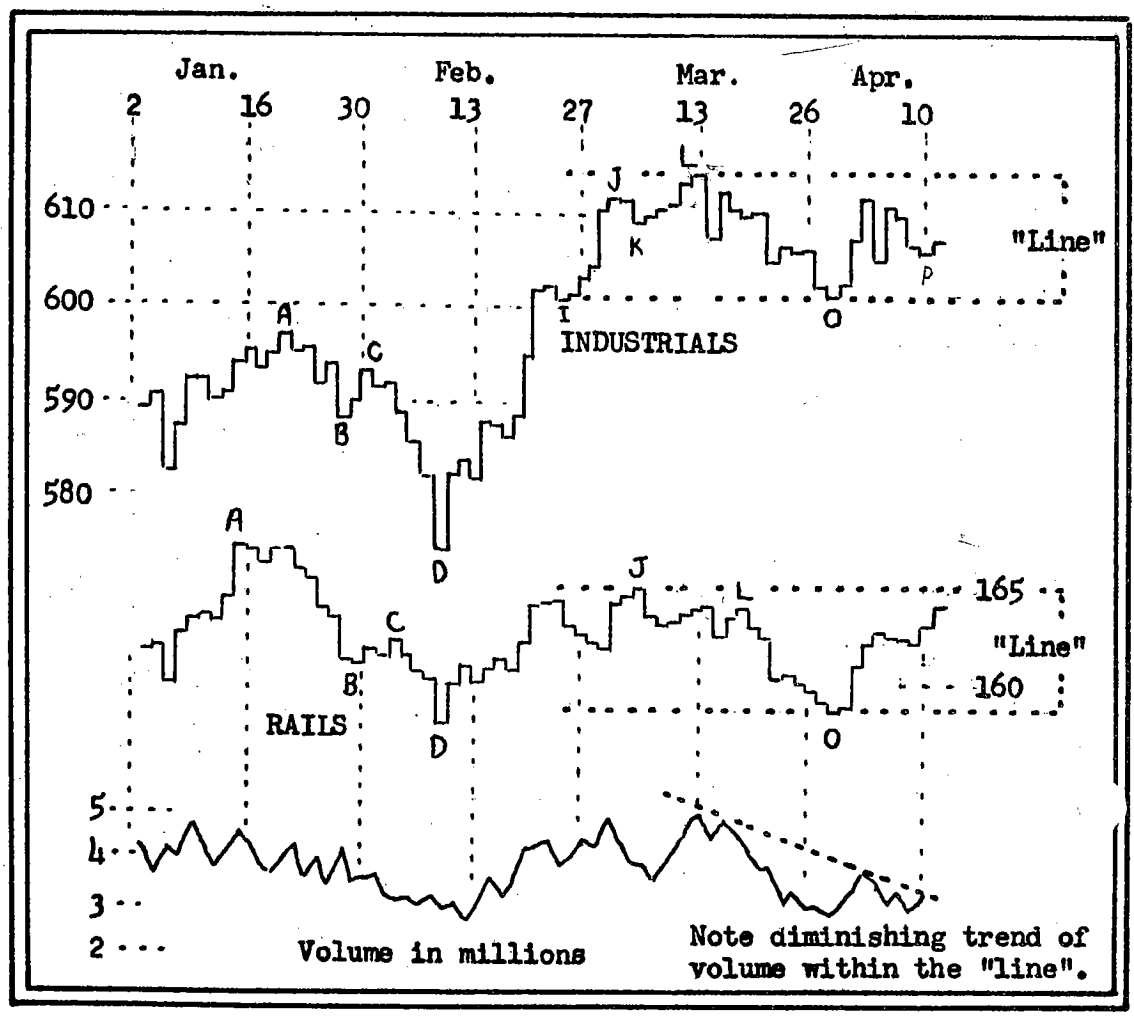
No two investors possess the same temperment, needs, or financial position. Yet each man should follow some method or plan in handling his individual portfolio. During the third phase of a bull market near the highs of a 200 point uncorrected advance, some men can sleep soundly with their entire fortune completely invested in common stock, and others sleep better after scaling down their position and paying a visit to the local savings bank. Both groups can be excellent students of the market; both can be absolutely correct. I am by nature a cautious fellow, otherwise I doubt if I would ever have spent month after month pouring over the teachings and studies of other and often better analysts. It has been my conclusion that the more one learns in this business, the less inclined one is to be dogmatic. My attitude can best be described by the following quote from Rhea: "Those who try to profit by the advance and decline of security prices are perplexed perhaps 90% of the time, and it seems that perplexity increases with experience. It has seemed to this writer that unvarying cocksureness on the part of traders and investment advisors is a badge of incompetence. There is, nevertheless, a time and place for certainty where the market is concerned, but such times and places are few and far between."

It is my belief that we are now about halfway through the third phase of this bull market. Most people fail to realize that all stocks do not top out of a bull market at the same time, and this is a further problem to be considered. During the 1929 debacle, for instance, of the 700 listed stocks, 262 hit their highs before the start of 1929 and 181 others had hit their highs before August of 1929 (the averages hit theirs in September). Chrysler hit its high of 160 in October of '28 and was 60 before the crash!

PRICE MOVEMENTS- A "LINE" IN THE AVERAGES (see chart). In Letter 59 I stated that the "general appearance of the averages suggests a line." Letter 60 noted that this rather short line was broken downside by both averages. On the ensuing decline, however, rails held 71¢ above their February lows (D) and industrials refused by 51¢ to penetrate their lows at point I, while volume dried up dramatically. Because of these indications, the downside violation of the line was not taken to be serious.

The averages since the line violation have formed the lower limits of what I consider to be a much longer and more important line. Between February 25 and the present, industrials have moved between a high of 614.69 (point L) and a low of 601.18 (point I). Rails during the same period have fluctuated between a high of 165.12 (point J) and a low of 158.65 (point O). In other words, industrials have moved within an area of 13.51 or 2.3% of the price of that average while rails have moved within an area of 6.47 or 4% of that average. This larger line has lasted 33 days, which is long enough to give us a strong prediction upon an eventual breakout by both averages in the same direction.

It is not necessary for a line to be penetrated by both averages on the same day, but the closer together (in time) the penetration, the more important the final prediction. A breakout of one average through the line limits is meaningless for prediction purposes and is often quite deceptive. If both averages go through the upper line limits (particularly on increasing volume), I believe the rails will shortly better their January highs of 167.38 and we will be in for a really sizable advance. If both averages violate the lower line limits (particularly on increasing volume) I feel that industrials will test the strength of the 574.46 lows established last February. If these lows do not hold, the chances of a secondary reaction will be better than at any time since early 1958.



VALID BUY-SPOT? Letter 61 stated: "If, on the next decline, one or both averages hold above the O points as volume diminishes, purchases can be made and we will call the area a buy-spot." So far, this is exactly what has happened. Both averages backed off and volume dropped to

2.8 million shares on the low point of last week's decline. Purchases certainly seemed warranted on the basis of this action, and these purchases should be retained unless the lower limits of the line are broken by both averages. This is a case of a buy-spot appearing within a line, which is not a particularly unusual occurrence.

TECHNICAL POSITION. Although the majority of lines are broken topside in bull markets, the technical condition of the market while a line is in progress is extremely important. The reason for this is that lines are, by definition, periods of very evenly matched buying and selling. The important thing to ascertain is--who is buying and who is selling. If buying is better informed than selling, both averages will eventually break the line topside. If selling is of better quality than buying, both averages will break the line downside. While it is true that a joint penetration of the line limits by both averages will constitute the final verdict, a study of the market's technical condition may help us to predict the final outcome.

(1) Barron's Low-priced Stock Index has tended to level off during the last few weeks after its recent steep climb. This could indicate an easing of the public's recent speculative fever, which would be bullish.

(2) Since January, the odd-lotter, though still buying on balance (which is normal), has been buying on a diminishing scale. This implies that there has been a trend to less selling or distribution by informed investors and also that the public is still far from being rampantly bullish.

(3) Because of the recent area of decreased volume, the ratio of the short interest to daily volume is probably rising, which is bullish. As this ratio climbs, the market becomes technically stronger, and the shorts are squeezed.

It would seem that as the "line" in the averages continues, a feeling of general caution is enveloping the public, and this cautious psychology is, of course, bullish. Based on the technical indications, I believe there is a good chance that the line will be broken topside.

STOCKS. The following stocks may be bought here: NORTHRUP AIRCRAFT, PEPSI COLA, CAPITAL AIRLINES, EASTERN AIRLINES, AMERICAN AIRLINES, PAN AMERICAN WORLD AIRWAYS (the entire airline group has broken upside and should be in for major moves). Some of the oils are beginning to look good on the charts: ATLANTIC REFINING and PHILLIPS look like buys. Would buy STANDARD OF JERSEY if it hits volume at 54, same with GETTY at 25-1/2. It is possible that the oil picture may be changing at last, and that this group may be heading up. Coppers have been very disappointing, but I would hold ANACONDA unless it broke 64 and MAGMA unless it broke 63. This is a volatile group and swings in either direction can be erratic. Would continue to hold or buy BECKMAN INSTRUMENT. The rail group is in a buying area and I like NEW YORK CENTRAL, B & O, ATCHISON, TOPEKA & SANTA FE, SOUTHERN PACIFIC. Some of the major steels are looking poor with U.S. and BETHLEHEM probably heading lower. LUKENS, however, looks excellent.
(written April 13, 1959 - 9 p.m.)

NOTICE: The questions and phone calls have been coming in at such a high rate that I must again repeat that it is impossible for me to answer everybody and continue to put out this Letter. I will try to answer the most important questions in these Letters, but the large majority of inquiries are from new readers who will become less perplexed as time goes on.

There will be a minimum of 40 mailings per year issued irregularly. The reason for this is that the market refuses to perform with anything like regularity, and I find that I must escape the burden of a weekly letter if I am to attempt to analyze important issues as they arise. It is possible that readers may receive two Letters ten days apart and then two during the same week. I believe that this is the best way of handling a Service which attempts to deal with the price movements in the stock market.